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BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
E. DAMADIAN, P. ZEROUNIAN, and) OTA NO. 18093766
C. NASSER,)
)
APPELLANT.)
)
_____)

Transcript of Proceedings, taken at
400 R Street, Sacramento, California, 95811,
commencing at 1:06 p.m. and concluding
at 2:05 p.m. on Monday, May 9, 2022,
reported by Ernalyn M. Alonzo, Hearing Reporter,
in and for the State of California.

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APPEARANCES:

Panel Lead: ALJ SUZANNE Brown

Panel Members: ALJ JOSHUA LAMBERT
ALJ ANDREW KWEE

For the Appellant: MITCHELL STRADFORD

For the Respondent: STATE OF CALIFORNIA
DEPARTMENT OF TAX AND
FEE ADMINISTRATION

RANDY SUAZO
KEVIN SMITH
JASON Parker

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1-5 were received at page 8.)

(Department's Exhibits A-F were received at page 9.)

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Sacramento, California; Wednesday, April 20, 2022

1:06 p.m.

JUDGE BROWN: We're on the record for the Appeal of the Partnership of Edward Damadian, Paul Zerounian, and Charles Arling Nasser, OTA Case ID 18093766. Today is Wednesday, April 20th, 2022, and it is approximately 1:06 p.m. We're holding this hearing in Sacramento, California.

The panel for today's hearing consist of myself. I am Susan Brown, and my co-panelists Judge Josh Lambert and Judge Andrew Kwee. As I explained earlier, the notice of panel identified Judge Sarah Hosey as one of the ALJs on the panel, but she's unavailable today and, therefore, Judge Andrew Kwee is available to substitute in her place.

Does either party have any objection to waiving the 15-day period for submitting a motion to recuse an ALJ for good cause and allowing Judge Kwee to substitute for Judge Hosey today. First, I'll ask CDTFA.

Any objection.

MR. SUAZO: No objection.

JUDGE BROWN: And I'll ask Appellant.

Any objection.

MR. STRADFORD: No objection.

JUDGE BROWN: Thank you both very much.

1 And next I'll ask Appellant's representatives to
2 please identify themselves for the record or
3 representative. Sorry.

4 MR. STRADFORD: My name is Mitchell Stradford
5 representing the Partnership of Edward Damadian, et al.

6 JUDGE BROWN: Okay. And CDTFA, I will ask your
7 representatives to identify each of you for the record.

8 MR. SUAZO: Randy Suazo, Hearing Representative,
9 CDTFA.

10 MR. PARKER: Jason Parker, chief of Headquarters
11 Operation Bureau with CDTFA, and we also have Kevin Smith,
12 Tax Counsel with CDTFA in the Audience.

13 JUDGE BROWN: Thank you.

14 All right. I will just briefly go over a few
15 logistics. As everyone knows, OTA is a separate
16 independent agency. We are independent from the
17 California Department of Tax and Fee Administration and
18 any other tax agency.

19 Although I am lead ALJ, for purposes of
20 conducting this hearing today, all three ALJs are coequal
21 decision makers in this process and are free to ask
22 questions at any time. When we have completed this
23 hearing, the panel will meet and confer and will issue a
24 written opinion on this case within 100 days of the
25 hearing. All right.

1 I'm just going to confirm that I issued a
2 prehearing conference. I mean, I've issued two prehearing
3 conference minutes and orders in this case. The most
4 recent one was dated April 8, 2022. And as I confirmed in
5 that prehearing conference minutes and orders, the issue
6 for the hearing today is whether further adjustments are
7 warranted to the audited understatement of reported
8 taxable sales for the liability of January 1st, 2009,
9 through December 31, 2011.

10 Appellant, Mr. Stradford can you confirm that's
11 the issue for hearing today?

12 MR. STRADFORD: Yes, that's correct.

13 JUDGE BROWN: Is your microphone on?

14 MR. STRADFORD: It is. Yes, that's correct.

15 JUDGE BROWN: Okay. Thank you.

16 And, CDTFA, can you confirm as well that's the
17 issue for hearing today?

18 MR. SUAZO: That's the issue today.

19 JUDGE BROWN: Okay. I'll also confirm, as we
20 discussed during the prehearing conference, and I wrote in
21 the minutes and orders, that neither party is calling any
22 witnesses today.

23 And I want to confirm the exhibits that we also
24 discussed during the prehearing conference. We have
25 documentary exhibits that are proposed for admission into

1 evidence. Everyone is aware that OTA's regulations
2 require that proposed exhibits must be submitted at least
3 15 days in advance of the hearing. Each party has
4 submitted proposed exhibits. Appellant has submitted
5 proposed Exhibits Numbers 1 through 5, and CDTFA has
6 submitted proposed Exhibits A through F, and the Office of
7 Tax Appeals distributed a Share Point link with a copy of
8 these exhibits. And neither party raised any concerns
9 about missing pages or any problems with those exhibits.

10 And during the prehearing conference, as
11 confirmed in the prehearing conference minutes and orders,
12 the parties indicated they did not anticipate having any
13 objection to admission of the other party's exhibits.
14 I'll start with Appellant's Exhibits 1 through 5.

15 Am I correct that there's no objection to
16 admission of Appellant's Exhibits 1 through 5 into
17 evidence?

18 MR. SUAZO: No objections.

19 JUDGE BROWN: Okay. Then Appellant's Exhibits 1
20 through 5 are admitted.

21 (Appellant's Exhibits 1-5 were received
22 in evidence by the Administrative Law Judge.)

23 And next I'll move onto CDTFA's Exhibits A
24 through F.

25 Mr. Stradford, can I confirm that Appellant has

1 no objection to Exhibits A through F being admitted into
2 evidence?

3 MR. STRADFORD: We have no objections.

4 JUDGE BROWN: Okay. Thank you.

5 CDTFA's Exhibits A through F are admitted into
6 evidence.

7 (Department's Exhibits A-F were received in
8 evidence by the Administrative Law Judge.)

9 And as we also discussed, during the prehearing
10 conference and confirmed in my minutes and orders, the
11 order of events today is going to be that first, Appellant
12 will make a presentation. We had a time estimate of
13 approximately 30 minutes, and then CDTFA will make a
14 presentation. We have a time estimate of approximately
15 20 minutes. At that point we may have questions from the
16 ALJs. While my co-panelists are welcome to ask questions
17 at any time, I anticipate that I will let both parties
18 make their presentations before we have the main
19 questioning period. After that, we have Appellant's
20 rebuttal and closing argument which may take up to
21 15 minutes.

22 Are there any questions about any of the
23 proceedings that I have just described or anything that
24 anyone wants to raise at this point? Mr. Stradford?

25 MR. STRADFORD: No.

1 JUDGE BROWN: You mean, do you have any
2 questions?

3 MR. STRADFORD: Oh, no, I do not.

4 JUDGE BROWN: Okay. CDTF, do you have any
5 questions or anything?

6 MR. SUAZO: No questions.

7 JUDGE BROWN: All right. Co-panelist? Okay.

8 Then I think I have covered everything. I've
9 admitted the evidence, and we discussed the timeline. So
10 I believe we can proceed with Appellant's presentation.

11 Any time you are ready, Mr. Stradford. Just make
12 sure that you speak up loudly and clearly and that your
13 microphone is on.

14 And I will turn mine off.

15 MR. STRADFORD: Thank you, Judge Brown.

16

17 PRESENTATION

18 MR. STRADFORD: This case involves an audit of a
19 cafe-style restaurant located in Lancaster. CDTF audited
20 Appellant for periods January 1st, 2009 through
21 December 31st, 2011. The primary audit methodology relied
22 upon by CDTF is an extrapolation of an observation test
23 using a credit card sale percentage against credit card
24 deposits. In summary, an observation test consisted of an
25 auditor visiting the taxpayer's location to observe,

1 record, and later analyze the business activities.
2 Typically at least three days are observed. So it is a
3 very small sampling of the business activity overall.

4 The primary issue in this case is whether or not
5 Appellant, the Partnership of Edward Damadian, et al.,
6 accurately reported its taxable sales. We believe the
7 evidence supports that Appellant accurately reported its
8 taxable sales. The only reason that we are here today is
9 because of a combination of incompetence and malfeasance
10 by employees of CDTFA. In our presentation we will
11 discuss the history of the case, which includes the
12 various ways in which the audit was performed incorrectly,
13 the recommendations initially made by the Appeals Bureau
14 to correct the errors made by the auditor, the actions of
15 BTFD's Board hearing representative to artificially
16 inflate the liability, as well as Appeals Bureau's ex
17 parte communications with the hearing representative to
18 eventually assert the overstated liability.

19 There should be no doubt that the CDTFA did not
20 act in good faith, and that Appellant has been treated
21 unfairly from the beginning of this process. We ask you
22 to be mindful of the history of this case when the
23 Department attempts to make representations of
24 reasonableness in their upcoming presentation. There is
25 no reasonableness that has occurred here. In CDTFA's own

1 words, this case is not defensible, and any
2 representations made by CDTFA today to the contrary are
3 patently false. Once we have finished discussing the
4 background of the case, we'll address the primary issues
5 regarding the computation of the audited taxable measure.

6 The first issue is whether or not the day of
7 observation of the business performed on January 7, 2013,
8 is a representative day of Appellant's business and,
9 therefore, should be used to extrapolate the sales during
10 the audit period. It is not representative, and we will
11 demonstrate why it is not.

12 The second issue is whether or not the resulting
13 credit card analysis of the business reflects that there
14 were any unreported taxable sales. The analysis supports
15 that the sales were all reported. Regarding the history
16 of the case, we'll first start with the basic explanation
17 of how the audit of a restaurant should be performed to
18 demonstrate how improperly it was done in this case.

19 The auditor should first request and review sales
20 records of the business and reconcile them to the reported
21 amounts. The auditor should then use a secondary audit
22 methodology, such as a credit card sale percentage
23 analysis, to evaluate the recorded and reported sales. In
24 this case, the auditor skipped or, at a minimum, did not
25 schedule the recorded sales. The auditor reviewed what

1 appears to be three bank statements from first quarter --
2 or second quarter 2011 and compared them to reported
3 taxable sales.

4 They computed the credit card deposits from that
5 quarter which represented 74 percent of the reported
6 taxable sales. They made no adjustments for tips and, as
7 a result, the percentage that they computed are
8 artificially high. The auditor apparently concluded,
9 based on this ad hoc analysis, that the sales of the
10 business were underreported. Based on that analysis, the
11 audit staff proceeded to schedule an observation test of
12 the business.

13 The first day that they chose was
14 January 7, 2013, followed by subsequent days on March 28th
15 and April 20th, 2013. Based on the audit history, it
16 appears that the first day of observation was initially
17 performed by the Ventura office due to its proximity to
18 the business location, whereas, the audit was performed by
19 the Culver City district. Initially, the observation test
20 was to be performed for three days in January on the 7th,
21 10th, and 12th of 2013, but the Ventura principal auditor
22 objected to the weekend day being used as a day of
23 observation, as he determined it was unnecessary.

24 As a result, the Culver City supervisor, who was
25 arranging the observation test, agreed to just do one day

1 of observation. Her email in that correspondence states,
2 "Would you just do one day on Monday, January 7, 2013? We
3 can review the total sales per day to determine if we need
4 to continue with the observation test. As of now, based
5 on bank statements, we should have no change the audit."

6 That conclusion was correct, and had that
7 recommendation been followed, we wouldn't be here today.
8 Before the observation test was even performed, CDTFA knew
9 that the audit should be a no change. That's the first
10 CDTFA employee that acknowledges this case should be a no
11 change. And as you will hear today, there are more CDTFA
12 employees that reached the same conclusion. Further, had
13 the analysis that she referred to even have been perform,
14 the ex-tax sales observed on that day were \$2,486. If you
15 multiple that times 360 days of business operation, that
16 yields annual sales of \$894,960, which is less than the
17 total sales reported in any three years of the audit.

18 So even if they had done the analysis that the
19 supervisor recommended, they would also have recommended a
20 no change after the first day of observation. The Ventura
21 office auditor who performed the January 7th, 2013,
22 observation test did not record the sales he observed.
23 Instead he emailed the receipts and various reports to the
24 Culver City auditor. The Culver City auditor scheduled
25 the receipts in the audit and then performed two

1 additional days of observation on March 28th and
2 April 20th, 2013.

3 In the course of making a records request under
4 the California Public Records Act, we received copies of
5 the receipts and the reports, as well as the Ventura
6 auditor's email to the Culver City auditor. First, we
7 note that on the email itself the Ventura auditor states,
8 "I was told by employees and Mr. Damadian that the
9 observed day was a slow day." We'll revisit that
10 statement when we get to why that day is not
11 representative.

12 Second, we note that when we reconcile the same
13 receipts with the audit schedule, we identified three
14 problems with the transactions, which are as follows:

15 The same receipts have been entered multiple
16 times on multiple occasions in the auditor's schedule.
17 The auditor made mistakes in classifying transactions as
18 paid for by cash and paid for by credit card. For
19 transactions in which the method of the payment could not
20 be identified solely from the receipt, a significantly
21 higher percentage of the transactions were noted as cash
22 transactions without any support, even though there's no
23 dispute that the majority of sales are paid for with
24 credit card. Based on the mishandling of the receipts
25 alone, it could be fairly concluded that the auditor was

1 incompetent, but it does not end there.

2 In reviewing the audit working papers, the
3 auditor also made several other mistakes that are very
4 unorthodox and contrary to CDTFA's own published policies
5 and procedures. Typically, the audit staff would utilize
6 the actual bank statements of a business or a 1099-K
7 filing from a merchant processor of a restaurant to
8 establish the credit card sales of the business. In this
9 case, the auditor used the bank statements from second
10 quarter 2011, compared the credit card receipts from that
11 quarter to reported sales, and then extrapolated the
12 credit card sales of the business from the reported
13 taxable sales to compute the credit card sales of the
14 business.

15 I have never seen an auditor do that before. The
16 auditor did not request the bank statements. They did not
17 request the 1099 reports. He adjusted the credit card
18 sales by removing sales tax solely based on what was
19 reported, even though his observation show that they
20 collected tax on every transaction. He failed to make an
21 adjustment in his computations for tips, even though he
22 observed the business for two days and saw numerous
23 instances of tips. Further, both of these adjustments are
24 standard and common in practically every audit of a
25 restaurant.

1 The initial audit contained so many errors that
2 it is difficult to overstate how poorly this audit was
3 done. We attended an appeals conference, and the appeals
4 conference auditor agreed with our contentions to remove
5 the first day of observation, use the actual credit card
6 sales of the business, and make the correct computational
7 adjustments for tips and tax. A Decision and
8 Recommendation was issued accordingly on
9 November 20th, 2015.

10 Based on those adjustments, reaudit working
11 papers were provided to us in January of 2016. The
12 working papers reflected an overall percentage of error of
13 4 percent and unreported taxable sales of \$111,000.
14 However, the reviewer assigned to review the reaudit
15 identified additional errors in the auditor's
16 computations. That is to say they couldn't even follow
17 the instructions provided by the Appeals Bureau and
18 recommended additional adjustments to the audit, this time
19 in Respondent's favor.

20 The first reaudit is reflected and Respondent's
21 exhibit was then provided to us in May 2016. The reaudit
22 reflected a percentage of error of 5.89 percent and
23 unreported taxable sales of \$162,325, as compared to
24 reported taxable sales of \$2,755,956. We disagreed with
25 the remaining audit results on the basis that the audit

1 was performed on a test basis using an observation method
2 which is well established to be an imperfect estimate.

3 While it may be a useful method to demonstrate
4 significant errors, the low percentage of errors is a
5 strong indication that the taxable sales were accurately
6 reported and, therefore, requested a hearing before the
7 members of the Board of Equalization to present our
8 contentions. The Board scheduled a hearing for our case
9 on March 29th, 2017. We submitted an opening brief for
10 the case on February 2nd, 2017. At this point, we
11 received correspondence that the hearing would be
12 deferred.

13 After the deferral, we received further
14 correspondence that the case would be referred to -- back
15 to the Appeals Bureau for the issuance of a supplemental
16 decision and recommendation. After we received that
17 notification, we requested additional clarification on the
18 communications that had occurred between our opening brief
19 filing and subsequent correspondence that the case has
20 been referred for supplemental decision and
21 recommendation. The response to our records request from
22 the CDTFA shows various communications regarding the case.

23 The first communication shows that on
24 February 2nd, 2017, the Board received our opening brief
25 and immediately forwarded a copy to a Scott Lambert, who

1 was the CDTFA hearing representative on the case that was
2 responsible for preparing a reply brief for the
3 Department. The brief was also forwarded to Jeff Angeja,
4 who was the appeals representative at Board hearings at
5 that time, as well as Kevin Hanks, who is the chief of
6 headquarter operations divisions at that time.

7 All these communications by the way were
8 submitted as Appellant's Exhibit Number 4. On that same
9 day, 36 minutes later Jeff Angeja wrote to Scott Lambert
10 with a cc to Kevin Hanks that he reviewed the brief, and
11 the remaining two sentences of that email were redacted.
12 Scott Lambert replied the same minute and said, "That will
13 make it easy to respond. Thanks."

14 I interrupt the redacted portion of the email to
15 state that the case should not be heard by the Board
16 because our contentions had significant merit. As a
17 result, the response would be easy to prepare. On
18 February 12th, Scott Lambert emailed Lisa Burke who
19 appears to have been responsible for writing the Board
20 hearing summary. Scott appears to have written a summary
21 of the reasons why he believed that the adjustments
22 recommended by the Appeals Bureau that were made to the
23 audit were incorrect. Lisa was out of the office, so
24 Scott forwarded his email to Jeff Angeja for a response.

25 Jeff responded, which is redacted, and then Scott

1 said, "Welcome back. I'm sure you're glad to be back.
2 Tomorrow is fine." I infer that Jeff said in his redacted
3 email that he was available to discuss the case on
4 February 13th, the next day. On February 13th, Scott
5 Lambert sent a large redacted email to Kevin Hanks who
6 wanted to discuss the case in the week after the next
7 Board hearing. Two days later is when we received the
8 letter from the Board of Equalization, dated
9 February 15th, which stated that the March 29th hearing
10 was going to be deferred in order to allow the Department
11 further time to evaluate whether additional adjustments
12 appear warranted and that the deferral request had been
13 granted.

14 At this time, I believe that the case has been
15 resolved, and the Department had agreed with our
16 contentions. On March 7th, Scott Lambert received an
17 email from Albert Lye, the Culver City principal auditor,
18 which is redacted, but probably has some sort of
19 explanation why the district of account thinks the
20 liability is inaccurate or understated. On March 9th,
21 Scott Lambert responded to an email from Jeff Angeja
22 wherein he stated, "Jeff, let me see if I can answer any
23 of your questions or add additional information before you
24 come to a conclusion. I'll get back to you -- I'll get
25 back in touch shortly."

1 Again, it appears quite obvious at this point
2 that Jeff Angeja's email indicates that the petition
3 should be granted, and that Scott Lambert is disagreeing
4 with that opinion. On March 10th, Scott Lambert wrote an
5 email to Jeff Angeja in which he states in part, "The
6 Department believes we have the means, i.e., source
7 documents to correct the first observation test. I think
8 this is the best way to go. If Appeals agrees to this, it
9 can be accomplished through an SD&R or a reaudit. It's
10 difficult for Department, though, to conduct a reaudit at
11 this point given the direction of the D&R, i.e., delete
12 the first observation test day. As we agreed the audit
13 cannot go forward the way it is. It is not defensible."

14 He continues to propose other ways to adjust the
15 audit upwards that are misguided. In my opinion, it seems
16 that the emails we do have, which are not redacted, are
17 clear that Scott Lambert, Jeff Angeja, Kevin Hanks, and
18 the Culver City audit staff were all communicating ex
19 parte without including us, which effectively they were
20 colluding to assert a higher liability against Appellant
21 in spite of a decision and recommendation that had already
22 been issued through the proper channels in which we were
23 able to participate.

24 I would ask you to ask the Department
25 representative if that is an appropriate or a common

1 practice, but it's not necessary because it's clearly not.
2 Notably, it's not permitted at all under the current
3 rules; the current rules for tax appeals or the OTA
4 regulations. Also, as I stated earlier to -- as I stated
5 earlier, both Jeff Angeja and Scott Lambert agreed that
6 the audit is not defensible without the flawed first day
7 of observation tests being added back to the audit.

8 So they apparently concluded that a supplemental
9 decision and recommendation must be issued so that they
10 can defend the audit in front of the members of the Board.
11 I would ask if they were so certain that the audit would
12 be objectively correct in modifying it in this fashion,
13 why they did not broach that openly with the Board at the
14 Board hearing where we would have an opportunity to
15 present our side of the case. The Board held the
16 authority to increase the liability if it was understated.
17 We believe that the answer to that question is that the
18 audit could not be objectively altered in an open forum
19 because it is not objectively correct in the proposed
20 manner. It's wrong.

21 As I mentioned earlier, at no point were we made
22 aware of these communications or were we included in
23 anyway, otherwise, we may have been able to address the
24 erroneous assertions that were made. On May 19th,
25 over two months after this discourse occurred, our client

1 received a letter from the Appeals conference auditor
2 Shalu Jogin dated May 9, 2017, in which she verbatim
3 repeats portions of Scott Lambert's email and request a
4 response in 30 days from us.

5 I contacted Ms. Jogin on June 2nd, 2017, and
6 requested a copy of the correspondence which allegedly
7 constituted a valid and timely request for
8 reconsideration. The Appeals Bureau does not generally
9 issue supplemental decisions and recommendations on D&Rs
10 that are over 18 months old, so this was quite odd.
11 Further, because the Appeals Bureau is supposed to be
12 independent from the audit staff and the Department, one
13 of the parties in the -- involved in the appeal is
14 required to make the requests for reconsideration pursuant
15 to the then-rules of tax appeals. So there must have been
16 a request for reconsideration.

17 Shortly thereafter, I received a copy of the
18 email that allegedly constituted a valid request for
19 reconsideration. I suspect that the only reason I
20 received that email in the first place, given the redacted
21 status of the other emails I requested later, is because
22 the Department failed to even make a timely formal request
23 for reconsideration. Typically, that's done on a BOE
24 letterhead in a formal memorandum and is prepared within
25 30 days of the issuance of the reaudit working papers.

1 Notably in this case, the email that is the,
2 quote, end quote, "Request For Reconsideration," does not
3 even actually request reconsideration. It basically
4 instructs Appeals to issue a supplemental decision and
5 recommendation which they would ultimately do seven months
6 later. It is difficult to state how unprecedented this is
7 in our experience and how widely inappropriate and
8 inequitable the actions of CDTFA were in this case.

9 Now, because Appellant reported its sales
10 accurately, you don't even have to make a decision on this
11 case based on all the crazy things the Department has
12 done. We can easily address the evidence that supports
13 that the reporting was accurate. First, they maintained
14 accurate and complete sales records. They prepared daily
15 sales sheets, which were summarized on the monthly work
16 sheets which were provided for 2011. We provided those
17 here as Appellant's Exhibit 1. The worksheets reconciled
18 the reported sales.

19 Notably, the sales work sheets contain both cash
20 and credit card sales. The credit card portions of the
21 sales receipt reconcile with the deposits made in the
22 bank. We prepared and submitted this analysis as part of
23 Appellant's Exhibit 2. Appellant hired an accountant to
24 prepare financial statements, sales tax returns, and
25 federal income tax returns. These were the actions taken

1 by prudent businesspeople that are reporting accurately.

2 When you compare the recorded and reported sales
3 with the ex-tax and ex tip credit card deposits for the
4 audit period, the credit card sale percentage that results
5 is 68.33 percent. That credit card sale percentage is
6 reasonable. We know that it is reasonable because the
7 Department observed two days of the business following the
8 audit period that shows that the credit card percentages
9 were 64 percent. That closely ties to the recorded and
10 reported credit card percentage.

11 We assume that the Department will attempt to
12 state that the markup is slow. First, the Department
13 continues to only rely upon the federal income tax return
14 cost of goods sold to compute the markup. We provided an
15 example of a profit and loss statement in the
16 corresponding monthly worksheet wherein Appellant's
17 accountant clearly mis-categorized payroll expenses into
18 food cost, thereby, decreasing the computed reflected
19 markup percentage. For federal income tax return
20 purposes, this has no effect on net taxable income.

21 But if it is not considered in the markup
22 computation, it results in a lower reflective markup that
23 is not usually accurate. We provided a month-by-month
24 markup analysis for 2011 using the actual recorded food
25 cost from the monthly worksheets that we referenced

1 previously. We made a reasonable allowance for spoilage,
2 waste, self-consumption and pilferage that is in
3 accordance with CDTFA Audit Manual Chapter 8.

4 The markups range from 164 to 218 percent by
5 month in that analysis, which is reasonable for this type
6 of restaurant. A low markup can equally mean one of two
7 things, that sales are understated or cost of goods is
8 overstated. It can mean each thing equally. You don't
9 know until you examine the underlying details of each
10 figure further. CDTFA often assumes that cost of goods
11 sold is accurate and sales are understated because people
12 rarely understate cost of goods sold for income tax
13 purposes.

14 But in this case, we have additional information
15 which clearly demonstrates the cost of goods sold are
16 overstated because they include payroll cost as opposed to
17 the actual cost of goods sold. This makes no difference
18 for income tax purposes as both are deductible items for
19 net taxable income. However, in computing the markup in a
20 sales and use tax analysis, it does impact the outcome.

21 In order for a sale to occur, the customer must
22 pay with cash or credit card. So if the credit card
23 analysis does not reflect that, sales are understated and
24 you have a low markup. This is because the cost of goods
25 sold is overstated or because they have a low markup in

1 general. In this particular case, we have the extra
2 benefit of being able to identify a specific instance
3 where payroll costs were erroneously and accidentally
4 recorded in food costs. So it is even clearer that the
5 cost of goods sold is overstated than it would be
6 otherwise.

7 If you exclude the highly questionable first day
8 of observation, the audited percentage of error drops to
9 5.89 percent. Excuse me. When using an observation test
10 that is known to be imperfect, such a low percentage of
11 error supports that the reporting is accurate. The
12 accuracy of the reporting in this case is further
13 supported by other evidence. Two days of observation
14 reflected a credit card sale percentage of 64.53 percent.

15 Those two days, the auditor was actually present
16 at the business and actually observed the sales. The
17 reported credit card sale percentage for the audit period
18 is 68.33 percent. Those percentages are very close and
19 well within the margin for error, considering only two
20 days of the business were observed. Coupled with the
21 extensive and complete records of the business, this
22 strongly supports that the recorded and reported sales are
23 accurate.

24 The Department also tried to assert a liability
25 using an average daily sales analysis, a cash payout

1 analysis, and a net income analysis. We have thoroughly
2 rebutted all of those methods by demonstrating that their
3 original computations contained errors, or that they
4 contain incorrect or invalid assumptions. Those purported
5 reason ability tests, once corrected, also support that
6 all the reported sales -- all of the sales were reported.

7 The only evidence -- and I mean the only evidence
8 that supports an understatement, is the single day of
9 observation that was ordered to be excluded by Appeals and
10 absolutely should be excluded. To further demonstrate why
11 that day should be excluded, we offer the following facts
12 and analysis. First, the credit card sales percentage on
13 the first day is 44.5 percent. It's drastically different
14 than the second and third days of testing, which were
15 64.55 and 64.51. That difference alone calls into
16 question the representative nature of the first day.

17 In the CDTFA's own Audit Manual in Chapter 8,
18 which describes the auditing of bars and restaurants,
19 there's a section on observation testing, wherein, they
20 specifically include in example where three days of
21 observation test performing is done, and there's a single
22 outlier day, it advises CDTFA staff to discuss with the
23 taxpayer and potentially replace that day with another
24 representative day or to expand testing.

25 Next, we note that the day in question,

1 January 7, 2013, total credit card sales for the business
2 were \$1,118. During the audit period, total credit card
3 sales were \$2,245,040. Assuming the business operated
4 360 days per year, that represents average daily credit
5 card sales of \$2,078, \$2,078, as compared to \$1,118. The
6 amount of credit card sales on the first day of
7 observation that we say is not representative -- which in
8 my opinion clearly is not -- is about half of the average
9 credit card sales of the business from the audit period.

10 As we noted in the auditor's email previously,
11 Appellant and his employees also noted that the day was
12 very slow. This is consistent with the results of the
13 observation test. In other words, it was not a
14 representative day and simple math makes that quite clear.
15 The first day of observation is just not representative.
16 The credit card percentage of 44 percent is abnormally low
17 on its face relative to businesses of a similar nature.
18 The credit card sales observed on that day were
19 approximately half of the average credit card sales that
20 the business had on a daily basis during the audit period.

21 And Appellant and his staff informed the auditor
22 that the sales were slow on the day of observation when
23 the observation was performed. The only reason we are
24 even discussing why this day is not representative, is
25 because according to CDTFA's own admission, the audit was

1 not defensible without it. The audit supervisor had it
2 right when she stated that the taxpayer's records were
3 supported and this audit should be a no change.

4 The Department had it right when they said this
5 audit was indefensible. We ask that you make it right and
6 accept the taxpayer's reported taxable sales. The
7 extenuating actions of the Department in this case are
8 absurd, and the fact that they took it upon themselves
9 through ex parte communications to manipulate the audit so
10 that it would be suitable for presentation before the
11 members of the Board is further evidence that the audit
12 is, in fact, overstated. If the audit could have been
13 presented before the members of the Board, there would
14 have been no need to go through all the trouble to have it
15 increased behind closed doors.

16 The evidence supports that the sales were
17 reported accurately, and we respectfully request that you
18 grant our appeal and order CDTFA to cancel the
19 determination.

20 Thank you.

21 JUDGE BROWN: Thank you, Mr. Stradford.

22 Co-panelists if you don't have any questions,
23 right now I'm going to go ahead and allow CDTFA to make
24 its presentation, and then we can have questions.

25 CDTFA, if you are ready, thank you for

1 remembering to turn on your microphone. And you can
2 proceed whenever you are ready.

3

4 PRESENTATION

5 MR. SUAZO: The Appellant is a partnership and
6 operated a diner-style restaurant with food and beverages,
7 including beer. The restaurant was open daily. All sales
8 reported is taxable. Records provided were federal income
9 tax returns, sales and use tax returns, and bank
10 statements for the audit period. Federal income tax
11 returns were scheduled for 2009, 2010, and 2011.
12 Comparison of total sales to sales and use tax returns
13 disclosed minor differences, Exhibit C, pages 140, and
14 141.

15 Markup analysis are recorded federal income tax
16 return sales to cost of goods sold showed low markup
17 percentages for all three years, with the overall markup
18 for the audit period being 136 percent; Exhibit C,
19 page 139. For this type of restaurant, the Department
20 would expect the markup to be much greater than the
21 136 percent observed. Bank statement analysis for the
22 audit period disclose that over 99 percent of deposits
23 were credit cards, less than 1 percent of deposits were
24 cash; Exhibit A, pages 47 and 48.

25 Reported sales were higher than amounts

1 deposited. Therefore, cash transactions were not
2 deposited into the Appellant's bank account. Comparison
3 of reported sales to credit card transactions on an ex-tax
4 basis reveal that just over 30 percent of reported sales
5 were paid using cash. Average ex-tax reported daily
6 sales, based on the restaurant operating 365 days a year,
7 equated to \$2,524 in total sales, of which \$1,725 were
8 credit card sales; Exhibit A, page 48; and \$799 in cash
9 sales, which is a difference between total sales and
10 credit card sales.

11 The Department conducted three observation tests,
12 and the results disclose cash payments accounted for
13 almost 40 percent of sales. 60 percent of sales were paid
14 with credit cards; Exhibit A page 19. Analysis of the
15 three-day test showed that the average credit card sales
16 of \$1,988 aligns closely with the average credit card
17 sales for the first quarter of 2013 of \$1,974. The daily
18 average credit card sales for the audit period is \$1,725.
19 The \$249 difference in daily average sales based on the
20 first quarter 2013 period reflects a growth rate of just
21 14.43 percent from the audit period.

22 However, the average ex-tax cash sales for the
23 three-day observation test of \$1,314, Exhibit A, page 19,
24 compared to the average reported daily cash sales for the
25 audit period of \$799, shows a difference of \$515 per day.

1 This reflects a growth rate of 64.45 percent in cash sales
2 since the audit period. The almost 50 percent difference
3 between cash growth rate and credit card growth rate is
4 not logical and supports the audit contention that not all
5 cash sales are being included in the Appellant's sales
6 records and are not being reported on the Appellant's
7 sales and use tax runs.

8 As prescribed by CDTFA Audit Manual
9 Section 810.30, the Department used all three observation
10 tests to compute and project a cash to credit card ratio
11 method. The Department divided the 60 percent credit card
12 ratio to the credit card sales to obtain total cash and
13 credit card sales of over \$3.1 million of taxable sales
14 for the audit period. The audited sales were compared to
15 the reported taxable sales of \$2.75 million to establish
16 unreported taxable sales of \$373,000 with a percentage of
17 error of almost 14 percent, Exhibit A, page 17.

18 A percentage of error was applied to each
19 quarter's reported taxable sales to arrive at unreported
20 taxable sales of \$373,156; Exhibit A, page 16. The
21 Department also performed other approaches to determine
22 unreported sales. A markup method was employed using
23 federal income tax returns cost of goods sold for the
24 audit period and applying industry average markup based on
25 third party publications; Exhibit A, page 56. Unreported

1 sales vary between \$378,000 to \$865,000 depending on the
2 range of the restaurant; Exhibit A, page 55.

3 The Department conducted a third approach by
4 comparing reported sales for the period from third quarter
5 2013 through third quarter 2014 to 1099-K credit card
6 sales, Exhibit A, page 53, to determine the ratio of cash
7 to credit card sales. The comparison showed a cash ratio
8 of over 36 percent. This translates to unreported sales
9 of roughly \$300,000, Exhibit A, page 54. For a
10 reasonableness test of the audit findings, a comparison of
11 taxable audited sales to recorded cost of goods sold for
12 the audit percent was 168.36 percent.

13 This markup aligns with the markup based on the
14 upper quartertile cost markup of 168 percent on Exhibit A,
15 page 55. Based on the approaches mentioned in this
16 presentation, the computed audited sales are accurate.
17 The Department used accepted audit methods and procedures
18 to determine audited sales amounts and the resulting audit
19 assessment. The Appellant has not provided substantive
20 documentation to support change to the audit findings.

21 Therefore, the Department request that the appeal
22 be denied. This concludes my presentation. I'm available
23 to answer any questions you may have.

24 JUDGE BROWN: Thank you, both.

25 First, I will turn to my co-panelists and ask if

1 they have any questions at this time.

2 JUDGE KWEE: I don't have any questions right
3 now. Thank you.

4 JUDGE BROWN: Judge Lambert?

5 JUDGE LAMBERT: I don't have any questions right
6 now. Thanks.

7 JUDGE BROWN: I may have a few questions. Let me
8 start with Appellant's representative. I actually just
9 have some very basic questions. These are not tricks,
10 just -- I wanted to just confirm because Appellant's --
11 there's no mention of Appellant claiming exemption for
12 food sales. There's no exemption claim on the sales and
13 use tax returns. There's no mention of cold food to go.
14 So can we presume that all Appellant's sales are taxable.

15 Oh, is your mic on?

16 MR. STRADFORD: Sorry. Yes. All their sales
17 were either taxable, or they charged tax reimbursement to
18 the extent that they were cold sales to go.

19 JUDGE BROWN: Okay. And everything I've seen
20 referencing -- references alcoholic beverages. Is that
21 just beer and wine, or does that also include distilled
22 spirits, liquor?

23 MR. STRADFORD: They had a small offering of beer
24 and wine. It's -- it's kind of like a -- like a Denny's
25 almost, but they focus more on lunch and dinner, like,

1 burgers and things like that.

2 JUDGE BROWN: So just beer and wine?

3 MR. STRADFORD: Just beer and wine.

4 JUDGE BROWN: Then I wanted to go back to your
5 reference. Well -- one second. In Appellant's briefing,
6 you make a -- Appellant made a reference to Audit Manual
7 Section 0802.65. And I don't remember if your brief
8 actually mentioned the specific one, but it's the
9 provision about a tolerance of 10 percent in audits of bar
10 selling distilled spirits.

11 MR. STRADFORD: Yeah. So I guess what's your --
12 I am familiar with that audit section. What's the
13 question?

14 JUDGE BROWN: I guess my question is I wasn't --
15 it wasn't clear to me if you were saying that that should
16 apply in this case.

17 MR. STRADFORD: I -- I -- I don't think that that
18 particular tolerance should apply. It's just an example
19 where when the percentage of error is low and a secondary
20 audit methodology the Department can't accept recorded
21 sales due to the inherent variances within the testing
22 procedure.

23 JUDGE BROWN: I'm sorry. I didn't hear your last
24 part.

25 MR. STRADFORD: When the percentage of error is

1 low, the audit staff will typically accept the recorded or
2 reported sales because there's inherent variances within
3 the testing procedures of a secondary audit methodology.

4 JUDGE BROWN: Okay. But you're not --

5 MR. STRADFORD: So that particular section
6 applies to an audit of a bar when they do a short shelf
7 test and evaluate the sales prior to expanding the audit
8 methodology. But it's an example of there being a small
9 percentage of error where the staff can accept the outcome
10 of their testing, you know, without proceeding further.

11 JUDGE BROWN: Okay. But you're -- but Appellant
12 is not claiming that for this particular case?

13 MR. STRADFORD: Well, yeah. It's not a law or
14 anything. It's just, you know, some general guidance to
15 the audit staff.

16 JUDGE BROWN: I wanted to ask about your
17 statement earlier -- hold on -- about how you're -- how
18 Appellant's calculations by -- by your firm include
19 allowances for pilferage and spoilage. I wanted to ask
20 are you saying that those should have been included when
21 the -- when CDTFA calculated the book markups?

22 MR. STRADFORD: I think they should, yes.

23 JUDGE BROWN: Is there --

24 MR. STRADFORD: Typically, the reason why is, you
25 know, typically when you're evaluating markups, what you

1 would do is you would perform a shelf test where you would
2 get purchase invoices for the food products sold or the
3 drinks. There's an example in Chapter 8 of the Audit
4 Manual. I think it's one of the exhibits, actually,
5 wherein they give an example of how a shelf test of a menu
6 item at a restaurant should be performed, and then the
7 computation of the markup on the individual item, they
8 make these adjustments.

9 So ours are consistent with the audit manual.
10 And then once you perform a shelf test, you compare it to
11 the overall recorded or reflective markup. So you should
12 be comparing apples to apples. You do a shelf test on
13 one, and then you compare it to the reported. In this
14 case, you know, they're just taking, like, a page out of a
15 report from Deloitte from six years later and comparing
16 that to the book markups on the income tax returns.

17 I don't -- I don't think that's appropriate, and
18 I think their analysis also fails to account for the cost
19 of food that aren't actually food. Our analysis does
20 account for that because we use the food cost off the
21 monthly worksheets instead of using the cost of goods sold
22 on the income tax returns.

23 JUDGE BROWN: I think that's all that I have
24 right now.

25 CDTFA, if you have any -- I guess I'll give you

1 an opportunity if there's anything that you want to add
2 that addresses the questions I was asking or Appellant's
3 responses. I'll give you that opportunity before --
4 before we move onto Appellant's closing argument.

5 MR. SUAZO: I just want to make a comment on
6 the -- on the markup.

7 JUDGE BROWN: Yes.

8 MR. SUAZO: And it's based on Exhibit F, pages
9 316 and 317. Basically, it reads, "Historically
10 business -- BTFD has calculated book markups without
11 making adjustments for self-consumption, pilferage, and
12 waste. And thus, the expected markups represent the
13 markups that --

14 JUDGE BROWN: Actually. I -- I -- I'm having
15 trouble hearing you.

16 MR. SUAZO: I'm sorry.

17 JUDGE BROWN: Is your microphone on?

18 MR. SUAZO: It's on.

19 JUDGE BROWN: Okay. That's better.

20 MR. SUAZO: Okay. "Historically, the Department
21 has calculated book markups without making adjustments for
22 self-consumption, pilferage, waste. And thus, the
23 expected markup represent -- the expected markups
24 represent the markups that would be computed without those
25 adjustments."

1 Thus -- thus, except for the erroneously,
2 including payroll cost and the cost of goods for 2011,
3 which the Appellant claims, we find that -- we find
4 nothing wrong with the Department's calculation of the
5 bookmark up in this case. We note that calculating the
6 book markups after making adjustments for
7 self-consumption, pilferage, and waste will result in
8 higher bookmarks and thus, computing book markups using
9 the method would result in higher expected markups.

10 In the case at hand, it was normal to calculate
11 the bookmarks after making adjustments for
12 self-consumption, pilferage, and waste. Then the expected
13 markup would be significantly higher than the 200 percent
14 markup that the Department expects in these types of
15 businesses. And that's in, again, Exhibit F, pages 316
16 and 317.

17 JUDGE BROWN: Okay. If my co-panelists don't
18 have anything further then --

19 JUDGE KWEE: I don't have any questions.

20 JUDGE BROWN: Then I think I can move on to
21 Appellant's rebuttal/closing argument, if you're ready,
22 Mr. Stradford.

23 MR. STRADFORD: Okay. Thank you.

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1 the fact that the reported sales are accurate.

2 The other issue that they raise is that the
3 Appellants did not deposit all the cash sales in the bank
4 or that the bank had very low cash deposits. Notably,
5 they reported a lot of cash sales, right? So I don't
6 really understand why that's -- that's relevant. You
7 know, restaurants typically don't deposit a lot of cash in
8 their bank because they pay out tips, and they often times
9 will do cash on demand to their vendors. So in this case,
10 I think the fact that none of the cash was deposited, yet,
11 a significant amount was reported on the sales tax returns
12 is further evidence that the taxpayer reported accurately
13 and reported all their sales.

14 Finally, you know, I guess with respect to the
15 inventory standards for the markup, there needs to -- you
16 can't just take a report seven years after the audit and
17 then use that as justification for some wacky audit
18 methodology. If you're going to do a markup, you should
19 do a shelf test. You should segregate the purchases.
20 There's a whole policy and procedure on how to do an
21 effective markup analysis. It shouldn't be used as an
22 excuse to add back in some bogus day of observation so
23 that you can look good in front of the members of the
24 Board.

25 And that's what I think was done here since the

1 Deloitte report was not present in the original appeals
2 proceedings and didn't become a matter of the record until
3 Scott Lambert was introducing it as a reason to have a
4 supplemental decision and recommendation issue.

5 And that's all I have on rebuttal. Thank you.

6 JUDGE BROWN: Thank you very much. If I've heard
7 everything from both parties, then I think I can move to
8 closing the hearing and submitting the case. Just a
9 second.

10 Since we've heard everything, I will say that the
11 exhibits have been admitted, I can say that this concludes
12 the hearing, and the record is closed, and the case is
13 submitted. The Judges will meet and decide the case based
14 on the evidence, arguments, and applicable law. We will
15 mail both parties our written decision no later than
16 100 days from today.

17 The hearing is now adjourned and this is also the
18 end of today's hearing.

19 Thank you everyone. Thank you all very much.

20 (Proceedings adjourned at 2:05 p.m.)

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HEARING REPORTER'S CERTIFICATE

I, Ernalyne M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 18th day of May, 2022.

ERNALYN M. ALONZO
HEARING REPORTER